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Financial Services

Insurers and Banks:

Levelling the Regulatory Playing Field

Mark R. Daniels

The Backgrounder in Brief

It is time to move beyond a prohibitionist stance toward banks' selling insurance and work toward balancing consumer protection and competition. There are outstanding issues, however, such as who would regulate banks' insurance sales. It is critical to resolve questions surrounding federal and provincial roles before going further on the road to expanded insurance powers for banks.

About the Author

Mark R. Daniels is a former academic and federal public servant. He also spent a number of years working with the life and health insurance industry. He currently lives in Summerland, British Columbia.

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Federal financial services legislation is up for renewal in spring 2007, the sunset date under current law as revised by the May 2, 2006, budget. A number of important technical questions are at play, but one outstanding and contentious issue seems to be whether banks will be allowed to market insurance selectively to their customers, either in or outside bank branches. Is there a case for continuing the prohibition on branch sales of most insurance products, or is it time to let more competition into the market?

There is some public policy substance to this debate — and a fair amount of unconvincing squabbling as well. This paper looks at the substantive issues, touches briefly on the squabbling, and proposes an end point.

The thesis is straightforward. A few years ago, there was a reasonable case — perhaps not ironclad — for keeping banks from making further inroads into the insurance business. Much of the case at the time centred around the perceived need to create a level playing field for the various providers of insurance services. It was argued that no group of providers should have significant legislative or regulatory advantages over another — that, broadly speaking, all parties should be bound by the same rules and operate under the same terms and conditions.

From a public policy perspective, it was difficult to argue that the limits on distribution should be permanent; there were some issues to be addressed and conditions to be met before significant policy changes could be contemplated. Now, the evidence suggests, in my view, that virtually all these matters have been dealt with and it is time to allow federally chartered deposit-taking institutions to join their counterparts in other countries in distributing a wider range of insurance products to their customers through their branches. Broader access to a range of insurance products — designed to mitigate personal and financial risk — supplied by an existing network of reliable, well-capitalized financial services providers is surely in the interest of consumers.[1]

In all this, however, one outstanding question has not been properly addressed: who is to regulate bank sales of insurance? Prudential regulation of federally chartered banks and insurance companies is the responsibility of the federal government. But the provinces are responsible for regulating insurance sales, while bank regulation is entirely under federal jurisdiction. Extending insurance sales to banks without providing a common regulatory regime invites creating a situation where insurance companies and banks are selling the same product in the same market under two different regulatory systems. Whatever the logic of full insurance powers for banks may be, failure to address this regulatory issue up front may throw a huge monkey wrench into the proceedings by creating a confusing and litigious marketplace.

The subject of banks in insurance always manages to generate considerable excitement among the parties to the debate. A number of reviewers on both sides of the question took the time to comment extensively on early drafts of this paper. I am grateful for those comments and I have tried where I could to accommodate their remarks to ensure accuracy and balance in my presentation. Needless to say, I remain entirely responsible for the content of the paper.

1 The potential for enhancing competition in the insurance marketplace, and the linkage to potential consumer benefits following therefrom, is discussed in detail in Horstmann, Mathewson, and Quigley (1996). Another comprehensive source that includes discussion of concerns about concentration in the banking sector is Mintz and Pesando (1996).

In tackling these issues, the practice under existing law will be outlined, the case against the banks reviewed, and the current situation assessed. Following a brief look at where the major market participants currently seem to stand, I comment on the all-important question of regulation and why it has to be dealt with. I then conclude with a few remarks on how that might be done.

The Current Framework

Federal

There is considerable scope under current federal legislation for insurance activities by banks and other deposit-taking institutions (DTIs). Banks can own and operate insurance subsidiaries and do so on exactly the same terms as other insurers. In 2004, the insurance subsidiaries of the five largest banks had $753 million in life and health insurance premiums, while the total for the life and health insurance industry was just over $58 billion (Canadian Life and Health Insurance Association 2005). These companies use the full range of distribution channels generally available to insurers and may offer a full range of products.

Banks also may distribute eight "authorized" types of insurance within their branches, largely group insurance products designed for creditor protection and travel insurance products.[2] By far the biggest authorized product is mortgage life insurance, with banks distributing the products of other insurance companies. Authorized products are also sometimes underwritten by bank insurance subsidiaries, but the amount is only a small fraction of the total value of insurance sales outside federally regulated DTIs.

With respect to other, non-authorized insurance products, within their branches banks may provide advice only of a general nature. Outside their branches, they may promote their own insurance products if they are not targeted to specific individuals or groups, which is to say that banks are not allowed to use information about their customers to target their insurance marketing selectively.

In addition, banks cannot act as agents in the sale of insurance nor can they provide space in their branches for anyone selling insurance. Moreover, banks may not carry on their business in a branch next to an insurance office unless there is a clear separation between the two facilities. And finally, banks cannot provide a telecommunications link from a branch to an insurance representative nor may they pass on customer information for promotional purposes.

Provincial

The situation in the provinces with respect to provincially chartered DTIs has generally tended to mirror that on the federal scene, although several provinces — with the historical example of Quebec and, more recently, British Columbia —

2 The eight kinds of "authorized" insurance are credit-card related, creditor's disability, creditor's life, creditor's loss of work, creditor's vehicle inventory, export credit, mortgage, and travel.

now allow credit unions and other provincially chartered DTIs to engage in limited in-branch promotion and distribution of insurance products. In addition, Ontario has circulated a consultation document that seeks public input into the question of whether or not provincially chartered DTIs in that province should have enhanced insurance distribution powers.

The Case against Bank Distribution of Insurance Products

An element of public interest in the insurance distribution activities of banks has been evident for a long time — as early as 1923, the Bank Act included special provisions in this regard. A decade ago, the insurance industry based its objections to the further entry of banks into its business on two general lines of argument.

First, there was a perception, reasonable or not, that banks and insurers could not compete on equal terms. It is important to note, in this regard, that, until 1991, insurance legislation had not been comprehensively reviewed in 60 years.[3] Thus, in the period following the 1991 legislation governing financial services companies, the insurance industry arguably required a substantial period of adjustment to a modernized legislative and regulatory framework. Any significant change in the distribution of insurance business powers was deemed, at least in some quarters, to be inappropriate, pending a reasonable adjustment period to the new legislative and regulatory framework.

Moreover, insurers argued, banks enjoyed certain legislatively bestowed advantages, such as access to the payments system and to government financial resources through the Canada Deposit Insurance Corporation (CDIC). In this latter case, it is necessary to recall that, in support of the bankruptcy of Confederation Life — the largest such case in North American history — the life and health insurance industry was in the process of funding its own consumer protection program, CompCorp (now Assuris), without any financial assistance in the form of temporary liquidity support from the Crown, such as was available through CDIC for numerous bank insolvencies. For the insurance industry, it was difficult to see how customer losses in the case of a life insurer bankruptcy differed from those of a bank customer in a bank insolvency, at least with respect to the case for a publicly funded consumer protection program. So, the industry argued, this lack of a level playing field in a comparable financial services marketplace needed to be fixed before any further changes in business powers ought to be contemplated.

Second, there was an on-going concern about the effect of increased insurance distribution by the banks on the possibility of coercive tied selling, abuses of privacy and personal information, and ensuring that sales intermediaries were appropriately trained and licensed. Again, the insurance industry argued, changes

3 The scope of the 1991 legislative reforms was significant: federally chartered financial institutions were given full powers in each other's traditional business domain. Thus, banks, trust companies, and insurers could all engage in one another's formerly separate businesses. The key exceptions were three: banks and trust companies would not be able to underwrite insurance directly nor sell most kinds of insurance; insurers could not take direct deposits (although they could own bank subsidiaries); and certain trust functions would remain the sole province of trust companies.

in these three areas were warranted before any changes in the framework for insurance distribution by DTIs.

Taken together, these points were deemed sufficient to make a case against any changes in the insurance distribution framework at the time, but three other considerations added to the balance of the argument.

First, the rather benignly expressed concern that the insurance industry needed some time to adjust to the major legislative and regulatory changes of 1991 masked an expectation, at least among some industry observers, that a significant consolidation of the industry in Canada needed to occur. However, that consolidation was not forthcoming under the largely mutual form of organization then prevalent in the industry, and demutualization required a change in legislation. It took the period from the later 1990s into 2002 to accomplish demutualization and subsequent industry consolidation. In my view, the substance of the "adjustment argument" disappeared at that point, but its validity can be seen in the play of events through the period. It is interesting to speculate how the reshaping of Canada's life insurance industry would have taken place had bank distribution of insurance then been liberalized. Some would argue that the outcome would have been very different indeed, mirroring the path of the consolidation among banks and investment dealers in the late 1980s.

Second, a word on the political environment at the time. Through most of the 1990s, the relationship between banks and parliamentarians was not particularly cordial — although this is not to say that personal relationships between bank leaders and ministers and senior officials were necessarily strained. By contrast, life and health industry agent associations were vocal opponents of bank involvement in their business, and beyond them the community of property and casualty insurance brokers were supremely effective lobbyists. They mobilized members from every region and sub-region of the country and effectively cultivated Members of Parliament. At the time, furthermore, federal regulators paid little attention to matters of market conduct within the banks, and there was no particular regulatory buffer to which MPs might otherwise have turned when responding to constituents' worries over their dealings with banks.

Given the political environment — and given that increased bank powers in insurance was not on its face a central public policy priority — no government was going to spend political capital on legislative changes favouring the banks. The House of Commons Standing Committee on Finance and Economic Affairs considered the question of increased bank powers in insurance at the time, but did not recommend changes. It is fair to say that, in that forum, there appeared to be little sympathy for the banks.

To that observation, one additional point needs to be made. At the time, the banks had not made their case particularly well for extending their insurance powers. "Bancassurance" was a relatively new business practice — there was little experience in Canada (except in Quebec) and the United States had yet to move into the arena in a significant way. Nor had European experience with bancassurance begun to make a strong impression as an option in the North American market. Moreover, the notion of a possibly underserved or underdeveloped insurance market available to the banks, while valid, was not

widely held. The focus on wealth management now evident among financial institutions did not strike as wide a chord then as it does in today's market.

A final word is needed here on the MacKay Task Force report (Canada 1998c), the template for the 2001 tranche of financial services legislative reforms. The report recommended dealing with issues surrounding the potential for coercive tied selling, privacy, and intermediary training and licensing issues, after which it would be possible to contemplate the phased entry of banks into the insurance field. The report also agreed with insurers on the competitive issues embodied in their exclusion from access to the payments system and a CDIC-type mechanism. In the end, not all of the report's recommendations were accepted, and the banks were put on hold with respect to insurance powers pending further consideration of the issues.

In the lead-up to the 2001 legislative changes, both the Senate Standing Committee on Banking, Trade and Commerce (Canada 1998b) and the House of Commons Finance Committee (Canada 1998a) also commented on increased insurance powers for DTIs. The Senate committee recommended that no new powers be granted to banks immediately, but that they should be able to offer life annuities to existing bank customers who were holders of registered retirement savings plans. The House committee took a more restrictive position against any change in powers, with the added requirement that the package of strong consumer provisions in the legislation be enacted and evaluated by the committee before the next legislative review or any subsequent reconsideration of extended bank insurance powers.

To conclude this discussion of the case against bank distribution of insurance products, it is important to stress that no single definitive line of argument was mustered against the banks. There were some issues of public policy and some of timing, all of which could be said to be contributing factors in the debate. But no consensus, explicit or otherwise, emerged as to the necessary or sufficient conditions for further bank entry into insurance retailing.

Where Are We Now?

Leading up to and following the 2001 legislative changes, a new regime has emerged that has begun to address earlier concerns about bank insurance retailing. Privacy provisions are now in place for federal institutions, including banking, as a result of the 2001 *Personal Information Protection and Electronic Documents Act* (PIPEDA), although it is somewhat unclear if the act's provisions are sufficient to suit a changing environment for the retailing of insurance products. For example, if banks were allowed to market property and casualty insurance to their mortgage applicants, would they be permitted to see the terms and pricing of existing property insurance contracts that they are competing against? And although consumers might find product bundling, such as of mortgages and home insurance, to be quite useful, does such bundling lead to coercive tied selling? PIPEDA's legislative and the regulatory framework should be able to guard against potential commercial abuses of private information in both the general and the life and health insurance markets.

Another important piece of legislation from 2001 was Bill C-8, the *Financial Consumer Agency Act*, which refined the prohibition against coercive tied selling practices. More important, the act provided for the establishment of the Financial Consumer Agency of Canada (FCAC) to ensure compliance with the consumer protection provisions embodied in all federal financial services legislation, to provide consumer education on available protection, and to monitor industry compliance with various voluntary codes of conduct. For the first time, there was to be at the federal level a comprehensive marketplace and market conduct regulator present for consumers of financial services. This, of course, was of particular relevance to banks, whose regulation is entirely in the hands of the federal government in these matters; for other parts of the financial services industry, regulation of market conduct and marketplace relations is largely a provincial matter.

Other consumer protection provisions also arose from the 2001 legislation. Bill C-8 required all federally chartered financial institutions to set up an internal complaints resolution procedure and to become members of an independent third-party dispute resolution process. The financial services industry sought government approval to set up an independent, industry-funded dispute resolution mechanism rather than have another public agency (or agencies) created. The federal government agreed, and a network of independent ombudsman services was established. This network was intended to provide a single reference point to link together the separate, independent dispute resolution services available for life insurance, property and casualty insurance, and, after some regrouping, banking and investment services. Initially, the network was structured as three industry-level ombudservices, along with a central coordinating body — the Centre for the Financial Services OmbudsNetwork (CFSON) — whose functions included helping develop uniform standards of dispute resolution and a call centre to direct consumers to the appropriate operating services. In early summer 2006, the industry ombudservices themselves agreed to assume responsibility directly for the coordinating function, and the CFSON was wound down.[4]

Together, the establishment of transparent (and, in many cases, new) internal dispute resolution processes inside companies, the network of independent industry ombudsman services, and the activities of the FCAC have built a substantial and important new capacity to deal in a timely and effective way with consumer issues and complaints. Indeed, in the past few years, few, if any, systemic consumer problems have had to move beyond these mechanisms to seek a fair hearing on appropriate redress. This does not mean that consumer problems have disappeared, but it does suggest they are being handled in a credible, timely manner.

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4 The ombudsman services may not have heard the last word on this situation since, from the point of view of the regulators, the role of the CFSON was integral to the successful functioning of the network. Absent assurances that application of standards, appropriate data reporting, and coordination generally can be handled directly by the services, regulators could seek changes that might even include the establishment of new public bodies to complement the privately run services.

It is also the case that the life and health insurance industry has undergone the radical reorganization and consolidation that was anticipated in the wake of the legislative reforms of the early 1990s. The key to this restructuring lay in the federal government's decision to allow demutualization to occur. After that, consolidation proceeded at a brisk pace; the industry structure in Canada now mirrors that of the banks, with several major players whose market capitalization is comparable to that of the big five banks.[5] In short, the industry readjustment expected to flow from the overhaul of the legislation nearly a decade and a half ago has taken place. Thus, I see no real case, at least on these grounds, to argue against bank competition in the insurance market.[6]

Finally, the insurance industry's concerns about having to compete with banks on an unequal basis, particularly because of their lack of access to the payments system and the CDIC, have been addressed to some degree. Insurers can now be members of the Canadian Payments Association, although not as direct clearers, and any advantage that CDIC backing might confer on the banks has become less valuable in the sense that improved economic conditions, regulatory oversight, and prudential requirements have made the likelihood of bankruptcies of either banks or insurers more remote. The situation could change, but as things stand today, the resonance of this aspect of the level-playing-field argument has been mitigated to some degree. At the same time, the extent to which these arguments ever held sway with policymakers in the context of this particular debate is unclear.

Where Do the Major Players Stand?

As of this writing, interested parties are reviewing a Finance Canada policy paper (Canada 2006) that sets out a series of proposals for the financial services legislative review to be put before Parliament in 2007. There is, however, no explicit proposal in the policy paper to increase bank insurance powers. Moreover, a 2005 Finance Canada consultation document (Canada 2005) made no mention of any move to increase bank insurance powers, nor did it explicitly seek any views on the matter in its call for submissions. Not surprisingly, few submissions raised the issue, and the positions of those that did developed along predictable lines.

One exception worth noting here, however, is the submission of the Canadian Bankers Association (2005). The CBA stops short of seeking full branch

5 At recent share prices, for example, the market capitalization of TD Bank Financial Group and the Bank of Nova Scotia was $47.9 billion and $47.5 billion, respectively, while that of Manulife Financial and Sun Life Financial was $56.0 billion and $26.4 billion, respectively. More generally, the Canadian Bankers Association, in its submission (2005, 65), points out that, in May 2005, the market capitalization of the top three banks was only 1.1 times as large as that of the top three life insurance financial groups.

6 Some opponents of increased bank insurance powers argue that such changes inevitably would reduce competition and thereby lead to more concentration in the banking sector. This is a complex issue, but there is certainly no consensus in the Canadian context that concentration in the banking sector is a problem requiring remedial action by government. The point is that Canada's existing institutional mechanisms, principally through the Competition Act, are able to deal with any problems that might arise from concentration. Thus, there does not seem to be a case for further action in this regard simply on a priori grounds.

distribution powers and instead seeks what appears to be a regime parallel to the one recently established in British Columbia for provincially chartered DTIs. This would give banks the right to make insurance information selectively available in their branches and, with customer approval, to make referrals to insurance professionals outside branches.[7] It is not entirely clear that the CBA's half-a-loaf approach will mitigate opposition more thoroughly than pursuing a whole package of powers, especially because the full-powers approach would better address the key distribution argument: to better serve a broad array of currently underserved middle- and lower-income Canadians. Indeed, the public policy case for broader bank insurance powers might be strengthened if the goal were in-branch services more effectively aimed at the underserved and underdeveloped market among lower-income families. The CBA's own discussion of the Quebec market and the insurance activities of caisses populaires seems to bear this out.

Licensing and Professional Qualifications: An Important Outstanding Issue

The core issue still to be resolved is embodied in insurers' concern that the same licensing and professional qualification regimes should apply to all insurance intermediaries, including the banks. This point marks a broader problem that needs resolution.

As noted earlier, bank regulation is the sole domain of the federal government, but market conduct and marketplace relations for insurance are provincial responsibilities. Yet, banks are already engaged in an uneasy standoff with provincial regulators over their sales of authorized types of insurance, even though such commodity-type products are commonly accepted to require a simpler regulatory regime. However, based on court decisions that banking is what banks do, banks argue that if they sell insurance, then that is "banking" — and hence a federal regulatory responsibility. From this anomaly has risen a number of court cases, including one now before the Supreme Court of Canada, questioning provincial authority to regulate one kind of insurance transaction or other.

In my view, however, this to-ing and fro-ing in court is unproductive and leading nowhere. Until now, it has not greatly affected insurers because the battleground has been restricted to authorized products that the banks already distribute, so the banks have not bumped directly into the insurance industry's distribution network. But if bank distribution of insurance becomes widespread, the prospect looms that the same products will be sold in the same market under different regulatory regimes. This would be unacceptable to insurance companies, sales intermediaries, provincial regulators, and, ultimately, consumers and their representatives in provincial and federal governments. It would be a serious mistake to let such a situation develop, especially if the matter could be headed off before it becomes a real problem.

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7 The Royal Bank, in its submission, went further than the CBA and sought full in-branch, networking powers (RBC Financial Group 2005).

The issue will have to be addressed eventually in any case, if banks begin distributing insurance generally. At that point, the federal government would have to get into the insurance regulation business, and real confusion would likely ensue — enough, perhaps, to dwarf the debate over securities regulation. Of course, all this potential conflict could also be settled amicably, but experience on the federal-provincial scene suggests otherwise. For customers who buy products, to whom would they turn in the event of a dispute? For banks that sell insurance in outside subsidiaries, who is the regulator?

The solution to this complex regulatory problem, however, seems rather obvious, and should involve the financial services industry itself, led by the banks, working with regulators to tackle it. Currently, bank insurance subsidiaries adhere to provincial regulatory requirements. It seems likely that the provinces would be amenable to extending those regimes to in-bank sales, as is already the case in British Columbia and Quebec, where provincially chartered DTIs sell insurance. With the provinces on side and agreement within the industry itself, the federal government could then be asked to extend provincial regimes to the banks by referencing their insurance regulations under the Bank Act.[8]

In fact, enforcement of and compliance with provincial regulations on bank insurance sales could be "contracted out" to the provinces in much the same way that the provinces cede some matters of prudential regulation in provincial DTIs to OSFI. There already exists in the Canadian Council of Insurance Regulators (CCIR) a good, long-established institution that has made considerable progress in addressing regulatory harmonization across jurisdictions in Canada. This forum provides an excellent venue in which industry and government can review issues on an on-going, timely, and systematic basis.

Banks might argue that such a solution would be just another regulatory complication and costly compliance requirement. But would it be? Remember, the issue has to be dealt with in any event; the idea here is that it could be dealt with better by, in effect, internalizing the solution in a private decision-making context. The industry has done this before in a much more dramatic way with its dispute resolution network, a broad self-regulatory scheme. An industry-led rationalization of a pending federal-provincial conflict should be a more manageable endeavour.

Finally, a concluding word on the CBA's current proposal for in-branch referrals. The idea is artful in one respect, in that it appears to avoid the regulatory dilemma of conflicting jurisdictions. Yet, even if it were not an issue at the outset, conflict over regulatory jurisdiction could be just down the road. New products, such as commodity-type life products, will likely emerge for which it is reasonable to contemplate a simpler set of regulatory requirements than life insurance currently confronts. The first time a bank butts heads on this point with a provincial regulator, a legal challenge will loom. But under a working

8 The potential difficulty of referencing provincial insurance regulations under the Bank Act has been mitigated by the recent addition of a provision to the Insurance Companies Act and the Bank Act that states: "The regulations may incorporate any material by reference regardless of its source and either as it exists on a particular date or as amended from time to time." The provision was not added in contemplation of insurance regulation, but perhaps it could do the job.

arrangement with the provincial regulators, there would be, through the CCIR, an orderly forum in which to contemplate change. To be sure, this would not guarantee a favourable outcome from the banks' perspective, but it would provide what seems to be generally missing now — an organized context in which to consider these evolving issues in a consistent and manageable fashion.

Conclusion

It is time to move beyond a prohibitionist stance toward the sale of insurance by banks, and to work toward a regime that offers the right balance of consumer protection, promotion of competition, and regulatory certainty. On consumer protection, policymakers need to satisfy themselves of the sufficiency of the recent framework's privacy controls and provisions that limit coercive tied selling. In addition, it would be wise to resolve the pending regulatory issue before going any further along the road to expanded insurance powers for banks. The issue will have to be addressed eventually, and it is in the interests of the financial services industry and, especially, their customers that this be done before problems emerge.

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NOTES

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